MAJOR ELECTRICITY USERS' GROUP

20th March 2015

Keston Ruxton
Manager
Market Assessment and Dairy
Regulation Branch
Commerce Commission

By email to regulation.branch@comcom.govt.nz

Dear Keston

Comments on scope, timing and focus for the review of input methodologies

1. This is a submission by the Major Electricity Users' Group (MEUG) on the Commerce Commission's[1] "Open letter on our proposed scope, timing and focus for the review of input methodologies (IM)" dated 27th February 2015. Members of MEUG have been consulted in the preparation of this submission. This submission is not confidential

2. Attached and to be read as part of the comments from MEUG is a memorandum from David de Boer of the New Zealand Institute for Economic Research (NZIER) titled "Input Methodologies review – Commission scope letter", 20th March 2015. This is referred to as the NZIER memo. The NZIER memo concludes with the following overall views:

   > "Our key observation is that the scope of the IM review needs to be expanded to consider the risks of stranded assets posed both by the slow response to the flattening of electricity demand and the potential for disruptive technologies to shift load patterns in the network. We suggest that the Commission expand the scope of the IM review to consider:
   >
   > - outlining a set of principles about how it will consider the allocation of the costs and risks of disruptive change between monopolies and consumers and also a materiality threshold for considering the effects of disruptive change.
   > - Increase the likelihood that monopolies and consumers are sending and receiving pricing signals that encourage 'efficient' adoption of disruptive technology by:

[1] http://www.comcom.govt.nz/dmsdocument/12992 at http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/amendments-and-clarifications/

  - reviewing the efficiency of the different pricing practices followed by lines companies and in particular how well the different menus of fixed , capacity (based on peak demand) and variable (based on the total amount of electricity supplied) reflect the cost of the services provided by lines companies.
  - Initiating discussion on how network pricing should be set for consumers that remain connected to the network but substantially reduce either the total amount of electricity consumed or change the profile of their peak demand
- prepare for the eventuality of stranded or under used assets by:
  - examining the assumptions about demand growth in lines company investment plans and requesting specific comment on the lines company planning assumptions for disruptive technology or sensitivity analysis of the investment requirements
  - considering scenarios for how the risk and costs of stranded or underemployed assets should be allocated between network service providers and consumers.
  - consider what tests the Commission would apply to determine if lines company investment in disruptive technologies would or would not be within the scope of the regulated asset base."

3. The remaining sections of this letter comment on the three questions listed in paragraph 33 of the open letter.

What time frame?

4. MEUG agrees with the logic in paragraphs 9 to 18 of the open letter and therefore we support the Commission proposal to review and amend all IM for all Part 4 regulated monopolies by December 2016.

5. The NZIER memo emphasises a need for urgency to get onto the front foot in terms of adapting our regulatory framework for material changes in demand and disruptive technologies that have already commenced. The earlier date to complete the review is not just desirable but essential. Achieving the earlier date to review the IM and ensuring outcomes maximise the possible long-term of consumers will be challenging but possible provided the points MEUG makes on consumer participation and integration with other agency work streams in paragraph 9 below are addressed.

Which IM should be included in the review at this stage?

6. The starting point for deciding which IM should be included is to undertake an assessment of what the scope of the review should be consistent with the requirements of the Act. We agree with the conclusion in the NZIER memo that:

> "Our key observation is that the scope of the IM review needs to be expanded to consider the risks of stranded assets posed both by the slow response to the flattening of electricity demand and the potential for disruptive technologies to shift load patterns in the network."

7. Whatever scope is finally decided there will likely be some IM that will in the review. Some preliminary views on IM topics are set out in the appendix.

What process should be followed?

8. Looking back at the implementation of the inaugural M over 2008 to 2010 there were processes that worked well and others not. The lack of effective participation by consumers and costly and long merit review processes are still issues. The use of specialist expert panels for particular IM that allowed Commissioners to ask questions was a useful change to previous approaches to conferences. The inaugural IM process also featured very good and adequate notice of future event timetables and that should be carried over for this review.

9. To achieve outcomes that will maximise the long-term benefit of consumers the review of IM must align with the following work by the Ministry of Business Innovation and Employment (MBIE) and Electricity Authority (EA):

    a) MBIE assessment of the merit review regime.

    It is essential that changes to merit review arising from the assessment should be in place well ahead of final IM decisions in December 2016 to provide certainty to parties on their appeal rights. The assessment of the merit review process will be complex and require expert advice. Because of the resource asymmetry between monopolies and consumers the assessment of the merit review regime will likely be a one-sided process.

    b) MBIE assessment of how to improve effective consumer participation in the evolution of the Commerce Act in general and in this instance Part 4 regulation and review of IM.

    This same problem of resource asymmetry noted above applies here.

    Some of the topics in the review of IM will be very material to all consumers. For example the debate on the anomaly acknowledged[2] by the Commerce Commission in using the Simplified Brennan-Lally version of the Capital Asset Pricing Model (CAPM) to estimate the Weighted Average Cost of Capital could, if new evidence is adduced to support prior arguments advanced by MEUG, result in electricity line costs paid by consumers reducing by between[3] $62 million and $132 million per year. Some monopolies argued solutions to this anomaly that would significantly increase line charges.

    Considering and if appropriate advancing propositions to the Commerce Commission and being able to provide sound countervailing views to alternative propositions by the monopolies requires independent experts. Commissioning such expertise is beyond the ability of most consumers. Even MEUG could not match the resources the monopolies employed across all IM for the inaugural IM and we do not expect to do so for the upcoming review.

    There is a risk that the inability for the majority of consumers to effectively engage in the detail of changes to IM will undermine confidence in and hence stability of Part 4 regulation. As debates on new technologies, greater consumer choice, and stranding risk to the monopolies intensifies; MEUG suggests risks of misinformation and hence undermining of consumer confidence in the regime increases. Facilitation of effective consumer involvement in evolving the regulatory regime will mitigate these risks.

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[2] High Court decision on merit review appeals, 11th December 2013, paragraph [1597], document URL http://www.comcom.govt.nz/dmsdocument/11470 at http://www.comcom.govt.nz/regulated-industries/input-methodologies-2/judgments/

[3] MEUG memo tabled with High Court in merit review appeal proceedings, "What's at stake?" 3rd September 2012, document URL http://www.meug.co.nz/includes/download.aspx?ID=123900 at web page http://www.meug.co.nz/Site/2012_Publications_archive.aspx

c) EA work on distribution and transmission pricing and use of system agreements.

A suite of robust and welfare maximising IM cannot be developed in isolation from how final prices consumers face are set. Hence integration of the timing and scope of the review of IM with relevant EA work programmes[4] is essential.

Opportunity to discuss

10. The members of MEUG and advisors to MEUG would welcome an opportunity to discuss with the Commerce Commission the NZIER memo and the comments in this letter. We also intend to seek opportunities to discuss with other consumers, regulated monopolies and retailers. NZIER note (paragraph 16):

> "Declining demand growth for energy, climate change concerns, strong growth of renewable local generation of electricity, energy storage systems and demand management as well as the use of smart technology in the operational management of grids have all combined to jump start what is now regarded as potentially the most profound changes to the energy industries since the initial development of the networks"

11. Just as the electricity industry is and will increasingly be subject to profound change then so too will and should the regulatory regime. All parties will be affected and hence we intend and encourage others to have an open discussion on the opportunities and risks to achieving outcomes for the long-term benefit of consumers.

Yours sincerely

Ralph Matthes
Executive Director

[4] For 2014/15 the relevant EA work programmes are # 1.6 transmission pricing investigation #1.9 review of more standardisation of use of systems agreements, #1.11 distribution pricing review and #1.8 research project: effects of low fixed charges.

Appendix

Cost of capital

The open letter (paragraph 31.1) lists 'split' cost of capital as a possible topic. MEUG suggest that is one of many solutions to the question of whether, when and what value(s) an 'uplift' is needed to meet the purpose of Part 4. Another solution is to estimate the linkages, or not, between regulated WACC and monopoly decision making for new investment as suggested by NZIER last year.

Another broad topic is to consider additional cross-checks and or complements to use of CAPM. Options that could be considered under this topic are first use of Fischer Black's "Simple Discounting Rule". Professor Meyers has been a supporter of this approach. Second a bottom up check to list and quantify the risks above risk free rate borne by Transpower, gas transmission companies and electricity and gas distributors.

Form of control (i.e. revenue versus price control)

Agree this should be a possible topic.

Asset Value

No detailed comment apart from noting MEUG members' are increasingly concerned about the quality and implementation of Asset Management Plans (AMP). If there were a driver from the asset value IM that might improve the usefulness of AMP then that should be part of the review. For example if new technologies are an emerging opportunity or threat to EDB then we would expect AMP to signal to users of networks how EDB intend to manage those changes.

We assume the reference (paragraph 31.6) to "implications for the depreciation of and indexation of asset values" in relation to the potential impact of disruptive technologies are just examples of possible solutions to the broader topic of how to treat stranding of regulated line assets and its relationship with the cost of capital IM. The NZIER memorandum comments in detail on the risks of stranded assets posed by both by the slow response to the flattening of electricity demand and the potential for disruptive technologies to shift load patterns in the network.

Cost allocation

This IM is not in the list of possible topics in the open letter. We think it should be because with disruptive technologies the boundary between what's contestable and what should be part of the regulated business is and will become unclear creating uncertainty for consumers, retailers, generators and monopolies. Under this broad topic we would expect a discussion on where assets and operating costs associated with new technologies should be allocated, whether there are dual till effects to be considered and whether changes are needed to overcome the opaque reconciliation of financial information on the boundary between regulated and un-regulated businesses owned by line monopolies.

Transpower Capital Expenditure IM

The open letter refers to this IM in paragraph 7 and the Commerce Commission intends it will be part of the review of all IM. MEUG agrees. This IM is important because it will need to align with any changes to transmission pricing for future investments. Lessons learned from implementing the existing Transpower Capital Expenditure IM and prior regulatory approval processes in recent and imminent decisions such as the Transpower application for approval of a $52 million cost overrun on the North Island Grid Upgrade Project (NIGUP) may be relevant.